In the Supreme Court of the United States

October Term, [illegible]

M. H. [illegible], Petitioner

v.

The United States

ON PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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85979—38——1

Miscellaneous:

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No. 98

M. E. BLATT COMPANY, PETITIONER

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OPINION BELOW

The opinion of the court below (R. 5–14) is reported in 23 F. Supp. 461.

JURISDICTION

The judgment of the Court of Claims was entered May 31, 1938 (R. 14). The petition for a writ of certiorari was filed June 7, 1938 (R. 14). The jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether the depreciated value of improvements to leased property made by a lessee as required by

the lease agreement constituted income to the lessor at the time of their completion.

STATUTE AND REGULATIONS INVOLVED

The pertinent portions of the applicable statute and Treasury regulations are set forth in the Appendix, *infra*, pp 15–16.

STATEMENT

The facts (R. 6–9) may be summarized as follows:

Petitioner, a corporation, made and filed a consolidated return of income for the taxable year ended January 31, 1932, for itself and a subsidiary corporation, the Mebco Realty Holding Company, (hereinafter referred to as the Realty Company), showing a tax due of $3,920.10, which was paid by petitioner (R. 6).

The Commissioner of Internal Revenue as a result of changes in the reported income of the Realty Company thereafter determined a deficiency in the tax amounting to $1,133.84, which was assessed against the petitioner and was paid by the petitioner September 5, 1934, with interest amounting to $160.41 (R. 6).

Among the changes so made which resulted in the deficiency was the addition to the income of the Realty Company of $1,742.31 as a result of the following transaction (R. 6–7):

On September 13, 1930, the Realty Company leased to the Ventnor Realty & Leasing Company

(herein referred to as the Ventnor Company) for use as a moving picture theater certain improved real estate owned by it in Atlantic City. The lease was for a term of ten years beginning upon the day certain improvements were completed by the landlord. With respect to the contemplated improvements the lease provided (R. 7):

> It is further agreed by and between the parties hereto that the landlord will, at its own cost and expense, make and complete alterations to the entrance and theatre, which is to accommodate as many seats as possible, and include plastering but no decorating, in accordance with the plans and specifications to be prepared by an architect to be selected by the parties hereto. It is further agreed that the tenant will paint and decorate, provided the landlord contributes a sum not exceeding Fifteen Hundred Dollars ($1,500) for such purpose to tenant. Tenant agrees to install the latest type of moving picture and talking apparatus, theatre seats, and all other fixtures, furniture, and equipment necessary for the successful operation of a modern up-to-date theatre, which shall at the expiration or other sooner determination of this lease become the property of the landlord.

On October 3, 1930, the Realty Company contracted for the making of alterations and improvements as contemplated by the parties to the lease, the contract providing that the Realty Company would pay the actual cost of the alterations and

improvements provided that the total cost, including contractor's profit and architect's fee, should not exceed $65,000, and that any additional work and materials ordered by the Ventnor Company would be paid for by it (R. 7).

All the alterations and improvements were completed in January 1931, and the Ventnor Company, as lessee, took possession of the property February 1, 1931 (R. 8).

The total cost of all the alterations and improvements was $114,468.77, which was charged to the lessor and lessee, respectively, and paid for by them, as follows (R. 8):

Paid by the Realty Company, lessor:		
Brick, steel, lumber, concrete	$45, 068. 73	
Heating and plumbing system	7, 716. 82	
Electrical work	8, 699. 84	
Ventilation system (partial)	3, 514. 61	
		$65, 000. 00
Building changes	661. 86	
New store fronts (4)	8, 132. 61	
		8, 794. 47
		73, 794. 47
Paid by the Ventnor Company, lessee:		
Ventilating system (balance)	3, 959. 75	
Decorating, glazing, and architect's fee	11, 313. 14	
Chairs	9, 167. 24	
Booth	5, 197. 39	
Draperies	7, 075. 42	
Electric signs and marquee	3, 961. 36	
		40, 674. 30
		114, 468. 77

The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was computed by the

Commissioner and was agreed to by the petitioner, as follows (R. 8):

	Cost	Depreciated value at end of 10 years
Ventilating system	$3,959.75	$2,771.83
Glazing, architect's fee, and other items	10,366.37	7,256.46
Painting	760.80	0
Other improvements	185.97	0
Chairs	9,167.24	3,055.75
Booth	5,197.39	0
Draperies	7,075.42	2,358.47
Electric signs and marquee	3,961.36	1,980.63
	$40,674.30	$17,423.14

The Commissioner of Internal Revenue in accordance with Article 63 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, *infra*, p. 15, included in the lessor's income for the year in which the improvements were completed, one-tenth of their depreciated value, or $1,742.31.

The additional tax paid by the petitioner for 1932 as the result of this addition of $1,742.31 to the income of the Realty Company amounted to $211.61 (R. 8).

Petitioner thereafter filed a timely claim for refund on the ground that the addition of $1,742.31 to the income of the Realty Company was incorrect. This claim was disallowed February 5, 1937 (R. 9).

This suit was brought in the Court of Claims on July 12, 1937 (R. 1).

Upon the foregoing facts the Court of Claims decided that petitioner was not entitled to recover and dismissed the petition (R. 9), holding that the

depreciated value of the improvements made by a lessee under the circumstances involved in the instant case is income to the lessor in the year in which such improvements are completed.

ARGUMENT

We submit that the holding of the court below is correct. The value of the improvements constituted a part of the rent and as such is taxable under Section 22 (a), Revenue Act of 1932, *infra*, p. 15.

The obligation on the part of the lessee to make the improvements was an unconditioned requirement of the lease and the fact that such improvements would be made must necessarily have been treated as part of the consideration for making the lease.

Income does not have to be received in the form of cash to be taxable under the Revenue Acts. *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176. For example, if a lessee agrees under the terms of the lease to pay taxes due upon the leased property, the amount so paid by the lessee constitutes taxable income to the lessor. *Commissioner* v. *Terre Haute Elec. Co.*, 67 F. (2d) 697 (C. C. A. 7th), certiorari denied, 292 U. S. 624.

Petitioner makes no contention in this case that the depreciated value of these improvements could not be determined. Nor does the fact that the lessor's use of the improvements was deferred re-

lieve the income whch they represent from taxation. It is not necessary that income be physically received to be taxable. As a result of the lease the lessor was deprived of the right to possession and beneficial use of the building and improvements until the end of the lease. But income is not divested of its character as such by an anticipatory arrangement which may limit its use or disposal by the taxpayer. *Lonsdale* v. *Commissioner,* 32 F. (2d) 537 (C. C. A. 8th), certiorari denied, 280 U. S. 575.

Under the circumstances of this case, where the improvements were clearly partial consideration for the lease, they were properly held to have constituted taxable gain to the lessor.

The holding of the court below is in accord with the long established administrative practice sustained by the preponderant authority of the decided cases.

The Treasury Regulations promulgated under the Revenue Acts of 1916 and 1918 provided that the depreciated value of improvements erected by a lessee constituted taxable income to the lessor upon the termination of the lease. Article 4, Par. 50, Regulations 33 (Rev. Ed.), and Article 48 of Regulations 45, respectively.

On May 5, 1919, in *Miller* v. *Gearin,* 258 Fed. 225, certiorari denied, 250 U. S. 667, the Circuit Court of Appeals for the Ninth Circuit decided that, assuming that the value of a building erected by a lessee

was income to the lessor, it was derived when the completed building was added to the real estate. The court stated (p. 226): "At that time it represented a prepayment to the lessor of a portion of the rental, distributable over a period of 23 years." To the same effect is *Cryan* v. *Wardell*, 263 Fed. 248 (N. D. Cal.).

As a result of these two decisions, the Commissioner, in 1920, promulgated T. D. 3062, 3 Cumulative Bulletin 109, which amended Article 48 of Regulations 45, *supra*, to provide that the fair market value of improvements erected by a lessee constituted income to the lessor upon their erection.

Article 48 of Regulations 62, promulgated under the Revenue Act of 1921, permitted the lessor at his option either to report the income resulting from the construction of improvements as income for the year in which the improvements were completed to the extent of their fair market value, subject to the lease, or to return the estimated depreciated value of such improvements at the end of the lease as income in aliquot parts spread over the remaining life of the lease.

These same provisions with minor changes were incorporated in substance in Article 48 of Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively; Article 63 of Regulations 74, promulgated under the Revenue Act of 1928; Article 63 of Regulations 77, *infra*; Article 22 (a)-13 of Regulations 86 and 94, promul-

gated under the Revenue Acts of 1934 and 1936, respectively.

Thus, for eighteen years the Treasury Department has uniformly followed the practice of treating such improvements as income to the lessor.

During that time Congress has repeatedly reenacted the provision defining gross income without making in change in this respect. It is clear, therefore, that Congress has given approval to the administrative practice. *Brewster* v. *Gage,* 280 U. S. 327; *McCaughn* v. *Hershey Chocolate Co.,* 283 U. S. 488; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552; *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269.

The cases of *Miller* v. *Gearin* and *Cryan* v. *Wardell, supra,* have been interpreted by the Circuit Court of Appeals for the First Circuit in *United States* v. *Boston & Providence R. R. Corp.* 37 F. (2d) 670, and *Crane* v. *Commissioner,* 68 F. (2d) 640; and by the Board of Tax Appeals in *Scott* v. *Commissioner,* 9 B. T. A. 1219; *Alexander* v. *Commissioner,* 13 B. T. A. 1169; *Martin* v. *Commissioner,* 24 B. T. A. 813; *Morphy* v. *Commissioner,* 35 B. T. A. 289; and *Sloan* v. *Commissioner,* 36 B. T. A. 370, as authority for the proposition that the depreciated value of improvements on leased property is income to the lessor at the time the improvements are erected.

Petitioner contends that the decision of the court below is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Hewitt Realty Co.* v. *Commissioner*, 76 F. (2d) 880. In that case property was leased in 1929 for a term of twenty-one years with the contingent option to the lessee to renew for three successive like periods. The option to renew the lease was contingent upon the lessee erecting a new building upon the land, although, except as a condition of the option, the lessee was not required by the lease to erect the new building. In 1931 the lessee erected a new building on the land, and the Commissioner included in the taxable income of the lessor an amount which represented the 1931 portion of the depreciated value of such building as of May 1, 1950 (the date of the termination of the lease), computed on the basis of a 40-year life.

The majority opinion of the Second Circuit holds that this amount did not constitute income to the lessor in the year 1931, stating (p. 884):

> We concede that in a situation like that at bar a lessor need not receive money to be taxable; if improvements to land be portable—detachable machinery for example, which he can take off and sell as separate chattels—he receives income either when the lease is made, or when the term ends; for present purposes we need not say which. On the other hand, if the lease requires the les-

see to drain the land, or set out shade trees, or pave it, or grade it, or build a golf course, or a race track on it, we can see no difference between the resulting increase in its value and that arising from the growth of the surrounding neighborhood, or the increase in value of a share of stock. The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.

The court in that case furth holds that if a building so erected would be worthless when removed, it becomes income only when the land is sold. At the end of its opinion the court states also that another factor in reaching its conclusion was the fact that the lease was subject to renewal, which would make the depreciated value at termination of the lease difficult to determine in advance, since the date of such termination was uncertain.

The court below states that the *Hewitt* case is distinguishable upon the ground last mentioned—that the lease in the *Hewitt* case was subject to renewal—whereas the lease in this case was not renewable and the termination date was certain. While there is this factual distinction, and perhaps others, the majority opinion in the *Hewitt* case was not based primarily upon this circumstance, but

rather upon the character of the improvements constructed by the lessee, and the court held that the value of the buildings erected did not constitute income to the lessor until a sale or other disposition of the property occurred.

However, it also appears from the language quoted above from the opinion in the *Hewitt* case that the court there held that if improvements made by a lessee are portable and have value when removed from the land the depreciated value thereof constitutes income to the lessor, although the court leaves open the question of when such income accrues to the lessor. The improvements involved in this case are as follows (R. 8): Ventilating system; glazing, architects' fees, "and other items"; chairs; draperies; electric signs and marquee. It seems reasonably clear that the present case is not in conflict with the *Hewitt* case with respect to items such as chairs, draperies, and electric signs. Furthermore, in the absence of a finding that the marquee and ventilating system were not portable and would not have value if removed, no conflict has been definitely established with respect to these items. The same observation may be true as to the glazing. Although in all likelihood architects' fees would normally be incurred in connection with structural changes and would thus attach to the type of property held by the Second Circuit not to constitute income, even this does not appear con-

clusively, and the part of the lessee's total expenditure to be allocated to architects' fees is not disclosed.

CONCLUSION

The question whether the depreciated value of buildings erected by a lessee constitute income to the lessor at any time before the lessor disposes of the property is important from an administrative standpoint, and a clear difference of opinion exists with respect to it. Several District Court decisions cited in the petition have followed the *Hewitt* case, while the Board of Tax Appeals has held to the contrary in the decisions noted above in this Memorandum. Since the Court of Claims did not specifically limit its decision in this case to the particular types of property involved here, there may be a conflict between this case and the *Hewitt* case with respect to some of the items. Accordingly, the United States does not feel justified in opposing the petition unqualifiedly. However, it is deemed desirable to point out that because of the manner in which the improvements are itemized in this case and the indefiniteness of the record as to the exact character of the individual items, because the making of the improvements was an unconditional requirement of the lease here, and because it is not clear when the lessors' title to the improvements arose, the present case does not clearly present the question upon which a conflict

of opinion exists. Therefore we suggest that the present petition might appropriately be denied and the conflict in principle between the *Hewitt* case and this case resolved when the issue is more squarely presented.

Respectfully submitted.

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AUGUST 1938.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 63. *Improvements by lessees.*—When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.

(b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the expiration of the lease and report as income for each year of the lease an aliquot part thereof.

* * * * *

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